No. 10-622

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

S&M BRANDS, INC.,
TOBACCO DISCOUNT HOUSE #1, and MARK HEACOCK,

Petitioners,

—v.—

JAMES D. "BUDDY" CALDWELL, in his official capacity as Attorney General of the State of Louisiana,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF OF *AMICI CURIAE* ON BEHALF OF FREEDOM HOLDINGS AND INTERNATIONAL TOBACCO PARTNERS LTD. IN SUPPORT OF PETITIONERS

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QUESTIONS PRESENTED

Forty-six States and numerous tobacco companies have signed an irrevocable agreement, called the Master Settlement Agreement ("MSA"), which divides markets, suppresses price competition, and restricts competitive advertising, with the purpose and effect of increasing both tobacco company profits and state revenues. It is undisputed that this agreement would violate the antitrust laws if entered into by the tobacco companies alone. The questions presented are:

1. Whether a binding agreement among multiple States and private companies is immunized from antitrust scrutiny under the state-action immunity doctrine of *Parker v. Brown*, 317 U.S. 341 (1943).

2. Whether a binding agreement among multiple States, with both intrastate and interstate effects, violates the Compact Clause, Article I, § 10, cl. 3 of the United States Constitution, in the absence of congressional approval.

TABLE OF CONTENTS

PAGE

QUESTIONS PRESENTED i

TABLE OF AUTHORITIES ii

INTEREST OF AMICI CURIAE 1

STATEMENT OF FACTS 5

The Agreed Upon Output Restraints Contained In The MSA Itself 7

The Origin And History Of Per Carton Penalties Imposed Upon The NPMs Through The Escrow Statutes 10

ARGUMENT 13

I. THE COLLECTIVE ENFORCEMENT BY THE SETTLING STATES OF THEIR STATUTES PENALIZING THE OUTPUT OF NPMS IN FURTHERANCE OF THE OUTPUT CARTEL SET UP IN THE MSA IS A CLEAR-CUT VIOLATION OF SECTION 1 OF THE SHERMAN ACT 13

A. Both FH VII And S&M Brands Are Able To Conclude That The Statutory Enforcement Penalties Do Not Create A Violation Of Section I Of The Sherman Act Only By Their Refusal To Look At The Relevant Market .. 14

PAGE

II. THE SAME UNDISPUTED FACTS ESTABLISHING THE DORMANT COMMERCE CLAUSE VIOLATION ALSO ESTABLISHED THE COMPACT CLAUSE VIOLATION..... 16

CONCLUSION..... 17

TABLE OF AUTHORITIES

Cases: PAGE

Freedom Holdings, Inc. v. Cuomo
___ F.3d ___, 2010 WL 4055566
(2d Cir. 2010) *(Petition for reh'g en banc filed)* ..... *passim*

Freedom Holdings, Inc. v. Spitzer
408 F.3d 112 (2d Cir. 2005) 3

Freedom Holdings, Inc. v. Spitzer
357 F.3d 205 (2d Cir. 2004) 3

Freedom Holdings, Inc. v. Spitzer
363 F.3d 149 (2d Cir. 2004) 3, 4

Freedom Holdings, Inc. v. Cuomo
592 F. Supp. 2d 684 (S.D.N.Y. 2009) ... 3, 12

Freedom Holdings, Inc. v. Spitzer
447 F. Supp. 2d 230 (S.D.N.Y. 2004) .3, 7, 11

Freedom Holdings, Inc. v. Spitzer
No. 02 Civ. 2939, 2004 WL 2251668
(S.D.N.Y. Oct. 6, 2004) 3, 12

Grand River Enters. Six Nations, Ltd. v. Pryor,425 F.3d 158 (2d Cir. 2005), *cert. denied*, 549 U.S. 951 (2006) 2, 4

Parker v. Brown,
317 U.S. 341 (1943) 3

S&M Brands v. Caldwell
614 F.3d 172 (5th Cir. 2010) 14

PAGE

Star Scientific, Inc. v. Beales,
278 F.3d 339 (4th Cir. 2002),
cert. denied, 537 U.S. 818 (2002) 11

Tritent Int'l Corp. v. Kentucky,
467 F.3d 544 (6th Cir. 2006) 15

Xcaliber Int'l Ltd. v. Caldwell,
612 F.3d 368, 375 (5th Cir. 2010)..... 14

Statutes

Section 1 of the Sherman Act,
15 U.S.C. § 1 .....2, 3, 13

Other Authorities

U.S. Constitution, Art. I, § 8, cl. 3. ..... 2, 4

U.S. Constitution, Art. I, § 10, cl. 3..... 16

INTEREST OF *AMICI CURIAE*[1]

Freedom Holdings and International Tobacco Partners Ltd. are importers of cigarettes made by firms that do not belong to the Master Settlement Agreement, defined in that agreement as Non-Participating Manufacturers ("NPMs") MSA § II(cc).[2] The pertinent provisions of the MSA are described in the Petition for Certiorari (pp. 3-8). The *amici* brought a class action on behalf of themselves and all other NPMs doing business in New York seeking injunctive relief against the Attorney General of New York and its chief financial officer prohibiting them from enforcing the New York State escrow statute that penalizes the output of NPMs as well as its Contraband Statute providing for forfeiture of the stamping license of any NPM that does not make full escrow payments. *FH VII* at *1. The MSA requires enactment and enforcement of escrow statutes substantially identical terms in all Settling States. MSA § IX(d)(2)(E) & (F). *FH VII* at *2. The Contraband Statutes, also in substantially identical terms, are enacted in 44 of the other 46 Settling States. They were enacted to

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[1] In accordance with Supreme Court rules, *Amici Curiae* have an interest in the outcome of this appeal and submit this brief to bring to the attention of the Court relevant matter not already brought to its attention by the parties. Sup. Ct. Rule 37.1. The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici curiae* or their counsel made a monetary contribution to its preparation or submission.

[2] The MSA is available in PDF form at http://www.naag.org/backpages/naag/tobacco/msa/msa-pdf.

enforce the covenant the States gave to the Majors to "diligently enforce" these Escrow Statutes. MSA § IX(d)(2)(B).

The Second Circuit has upheld *in personam* jurisdiction in the Southern District of New York over the Attorneys General of the various Settling States in the Southern District of New York finding that they collectively negotiated with the four Original Participating Manufacturers in the MSA (referred to herein as "OPMs" or the "Majors"), controlling over 90% of the national cigarette market in setting up the MSA that settled their potential, present and future product liability claims against the Majors for healthcare costs created by false promotion and claims of safety by the Majors for their cigarettes. *Grand River Enters. Six Nations, Ltd. v. Pryor*, 425 F.3d 158, 165-68 (2d Cir. 2005) ("*Grand River*"). *Grand River* held that an interlocking grid of these substantially identical output penalties, if proved to have resulted in higher prices nationwide would violate the dormant Commerce Clause. Art. I, § 8, cl. 3. The complaint in *Freedom Holdings* alleges that the enforcement of these statutes throughout the Settling States penalizing the output of NPMs violated both Section 1 of the Sherman Act, 15 U.S.C. § 1 and dormant Commerce Clause. Accordingly, a judgment against the New York Attorney General in *Freedom Holdings* prohibiting enforcement of the New York Escrow and Contraband Statutes will subject the attorneys general in the other Settling States to injunctive relief in the Southern District of New York and collaterally estop them from contesting such relief.

The prosecution of *Freedom Holdings* has been the subject of three reported district court decisions and four Second Circuit rulings.[3]

FH I, 357 F.3d at 223-24, held that if the factual allegations of the complaint before it were proved, it would establish that the State enforcement penalty statutes on NPMs were an integral of the MSA restraint of trade that established a violation of Section 1 of the Sherman Act. *FH I*, 357 F.3d at 223-24. It rejected as a matter of law the arguments of the Attorney General that these statutes constituted independent and unilateral acts of State enacted by the State in its governmental capacity. *Ibid.* Both *FH I* and *FH II*, in denying a petition *en banc* defense for rehearing filed by the Attorney General, also held that the state action immunity created in *Parker v. Brown*, 317 U.S. 341 (1943), was unavailable to the Attorney General because of the State's failure to actively supervise the pricing activity of the Majors. Following Supreme Court precedents, it ruled that such active supervision of pricing by the Majors was necessary for these enforcement statutes to qualify for such immunity. *FH I* at 231-32; *FH II* at 153. This latest Second Circuit decision, *FH VII* effectively overruled *FH I*,

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[3] *See Freedom Holdings, Inc. v. Spitzer* ("*FH I*"), 357 F.3d 205 (2d Cir. 2004); *Freedom Holdings, Inc. v. Spitzer* ("*FH II*"), 363 F.3d 149 (2d Cir. 2004); *Freedom Holdings, Inc. v. Spitzer* ("*FH III*"), 447 F. Supp. 2d 230 (S.D.N.Y. 2004); *Freedom Holdings, Inc. v. Spitzer* ("*FH IV*"), No. 02 Civ. 2939, 2004 WL 2251668 (S.D.N.Y. Oct. 6, 2004); *Freedom Holdings, Inc. v. Spitzer* ("*FH V*"), 408 F.3d 112, 115 (2d Cir. 2005); *Freedom Holdings, Inc. v. Cuomo* ("*FH VI*"), 592 F. Supp. 2d 684 (S.D.N.Y. 2009); *Freedom Holdings, inc. v. Cuomo* ("*FH VII*"), ___ F.3d ___, 2010 WL 4055566 (2d Cir. 2010).

FH II and *Grand River*, and is the subject of a petition to the Second Circuit for rehearing *en banc*, filed by the *amici* herein on November 1, 2010. That petition is currently pending.

FH VII held that as a matter of law, the State enforcement statutes penalizing the output of NPMs were unilateral acts of State that did not authorize or mandate illegal *per se* conduct by private parties and thus were not part of or in furtherance of an illegal *per se* scheme. *FH VII* at *8-*10. It also held that the Attorney General had established the affirmative defense of State action immunity, ruling that active supervision of the pricing activity of the Majors was not required, *FH VII* at *13, *19. *FH VII* further held that NPMs lacked standing under the antitrust laws to seek an injunction against enforcement of these State penalty statutes that have substantially eliminated competition in the Settling States. This was a *sua sponte* ruling. *FH VII* at *9.

As to the dormant Commerce Clause claim, U.S. Constitution, Art. I, § 8, cl. 3, *FH VII* effectively overruled *Grand River*. It did so by creating a *sua sponte* conclusion, contrary to undisputed fact, that the conduct of the States in collectively entering into the MSA and jointly pledging therein to the Majors that they would all enforce these output penalty statutes, MSA § IX(d)(2) simply consisted of independent uncoordinated acts by each of the Settling States, merely requiring "coincident obligations [by the NPMs] which may produce parallel price increases among the States." *FH VII* at *24. This *sua sponte* finding was made despite the acknowledgment in *FH VII* that the enforcement throughout the Settling States of these substantially identical statutes "has caused

cigarette prices to rise nationwide." *FH VII* at *23.

The resolution of the legal issues raised by the Petition for Certiorari are essentially the same as those presented in the Petition for Rehearing *en banc* in *FH VII*. These issues are fundamental ones going to the legality of the exercise of powers by a combination of States to set up and actively participate on a nationwide scale in commercial ventures with private industry. This activity consists of their collectively passing and enforcing state statutes penalizing unfavored firms in a particular industry to protect the market share of their partners, the firms in the MSA. Rather than the Court's passing forthwith on the instant Petition for Certiorari, we respectfully submit that it should hold a decision on the instant petition in abeyance pending a decision by the Second Circuit on the Petition for Rehearing *en banc* in *FH VII*. In the event the Second Circuit denies the Petition for Rehearing *en banc* on *FH VII*, then the *amici* will promptly file a petition for *certiorari* to this Court and ask that it be considered in conjunction with the instant petition in this case. In the event that that Petition for Rehearing *en banc* is granted, there is a substantial probability that the New York Attorney General, supported by the other Attorneys General in the Settling States will then seek a review of that ruling.

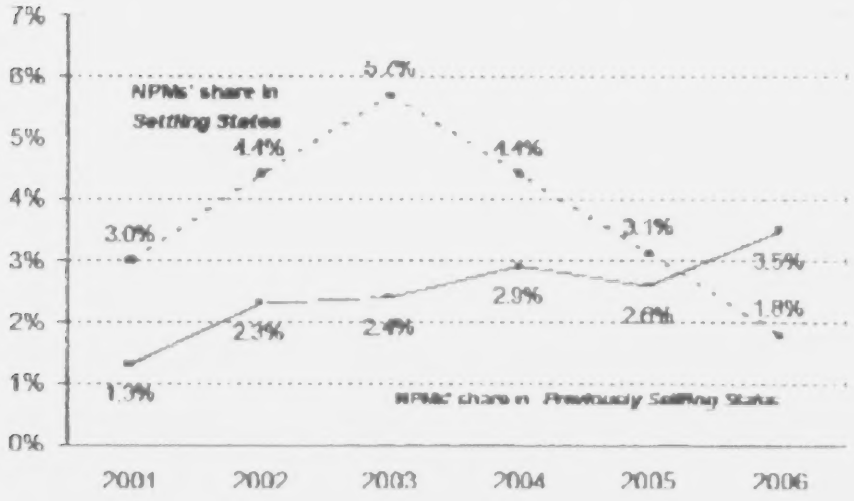
STATEMENT OF FACTS

The undisputed facts set forth herein establish the virulence of the MSA created anticompetitive statutory restraints. Counsel for the petitioners herein have informed us that the confidentiality

agreements entered in the trial court below suppressed most of these facts. These facts are in the public record in *FH VII* and will be briefly summarized here.

There are four Previously Settled States (the "PSS"). Each of them made independent settlement agreements with the Majors shortly prior to the Majors' inducing the Settling States to enter into the MSA in 1998. None of those PSS settlement agreements required any of them to enact statutory output penalties on the NPMs. The virulence of those restraints in the Settling States is graphically displayed in the following chart:

NPMs' Market Share in Previously Settling States vs. Settling States, 2001-2006
(per State Excise Tax data)



As revealed by the foregoing chart, the NPMs in the Settling States were able to compete through 2003, even after paying the output penalty contained in the Escrow Statute, although not as successfully as the NPMs in the PSS. Starting in 2000, however, the repeal of the Allocable Share Release provision (the "ASR")—the so-called

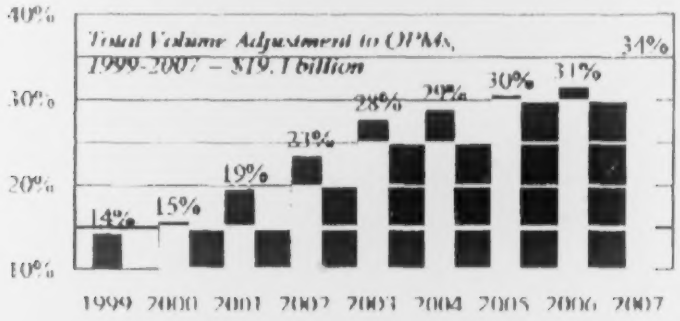
"Amendment" to the ASR that substantially upped the output penalties on NPMs, discussed *infra* at pp. 11-12, began to be enacted throughout the 46 States. By the end of 2006, this Amendment of the ASR throughout most of the Settling States had effectively eliminated the NPMs as viable competitors in the Settling States. Thus, by the end of 2006, the NPM sales in the four PSS were nearly double the sales of the NPMs in the 46 Settling States, and the market share of the NPMs in the Settling States has continued to decline, virtually eliminating them in the Settling States.

The Agreed Upon Output Restraints Contained In The MSA Itself

There are two output restraint mechanisms in the MSA: The Relative Market Share Adjustment, and the Volume Adjustment, MSA § IX(c)(ii). The Relative Market Share Adjustment penalizes any Major that gains market share at the expense of the other. It pegs the amount each Major pays as its share of the Base Annual Payment to the amount of cartons it sells nationally each year. Thus, the more share it gains, the more it has to pay to the others. The Volume Adjustment, an across-the-board bonus to all of the Majors, provides an incentive for all of them to reduce volume by raising prices. The less the Majors collectively sell in any given year, the less their annual settlement payment is to the Settling States. As the trial court explained in *FH III* at 257, "it rewards decreasing sales and punishes increases." Thus, the Majors have raised the prices virtually every year. This has reduced by billions of dollars of every year the annual settlement the States

receive from the Majors, as shown by the following chart:[4]

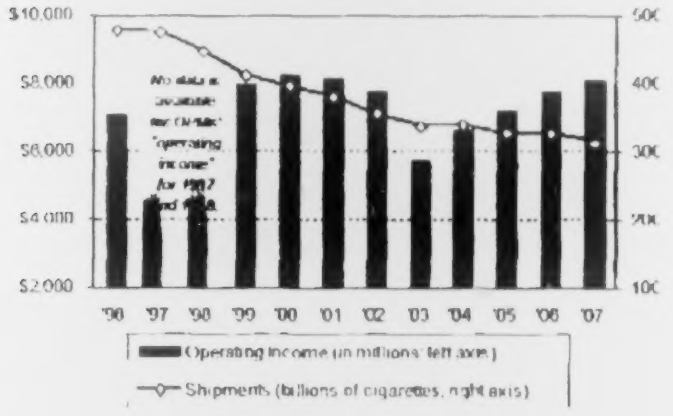
Rebates to the OPMs of MSA Annual Payments Due to Volume Adjustment (MSA Exh. E)



The objective of an output cartel is to increase operating profits of the participating firms by decreasing the amount of goods sold while at the time raising the unit prices of those goods. As shown by the following chart, the MSA output cartel has achieved this:

OPMs' Operating Income and Shipments

1999-2007

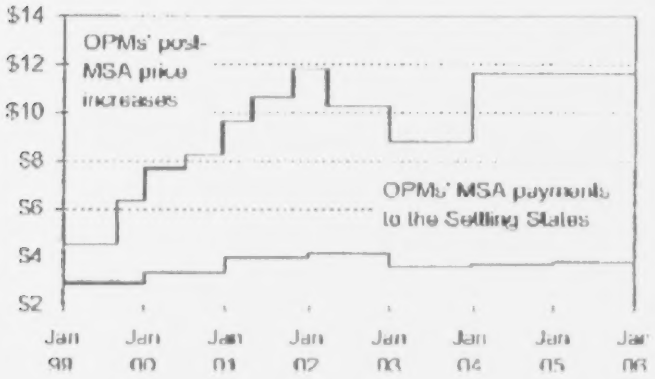


[4] All of the charts appearing in this petition come from the Opening Brief on appeal in *FH VII* and are based on data of record in the trial.

As the following chart reveals, the OPMs virtually doubled the wholesale price of premium cigarettes by a succession of price rises starting in late 1998, when the MSA went into effect, and continuing through 2001:

History of OPM's Price Rises (per carton)

1999-2005

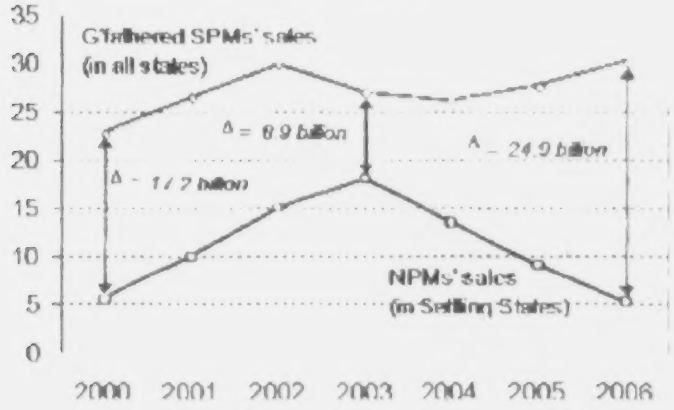


Starting in 2002 and continuing on through 2003, these price rises resulted in a decline in the operating income. This was due to a shift from the premium market occupied fully by the Majors to the lower priced end of the market, the deep discount market, where the NPMs and the grandfathered SPMs compete with each other. As noted, *supra*, p. 6, however, due to the continuing elimination of NPM sales starting in 2004, the Majors have pushed their prices back up to 2002 levels and restored their operating profits to 2001 levels.

As noted in *FH VII* at *1, grandfathered Subsequent Participating Manufacturers ("SPMs") are those small cigarette manufacturers in existence at the time the MSA became effective. To induce them to join the MSA, they were offered a perpetual bonus for signing within the ninety day

period following the execution of the MSA. This bonus consisted of an exemption from making any per carton annual settlement payments to the Settling States on all sales that did not exceed their 1998 market share or 125% of their 1997 market share, whichever was greater. MSA § IX(i)(1). This exemption, coupled with the repeal of the ASR, has enabled them to take away most of the NPM sales in the Settling States, as shown by the following chart:

NPMs' Sales Versus Grandfathered SPMs' Sales 2000-2006



The Origin And History Of Per Carton Penalties Imposed Upon the NPMs Through the Escrow Statutes

Both the Settling States and the Majors originally labored under the misapprehension that the accepted constitutional protections prevented them from totally controlling interstate commerce by compelling NPMs to make annual payments to the Settling States equivalent to those imposed on the non-grandfathered SPMs whose full MSA

annual settlement payments effectively disable them from competing.

Accordingly, the MSA had two provisions to overcome this constitutional obstacle: 1) It provided that Non-Participating Manufacturers would not make settlement payments to the States, but rather make per carton annual payments into State escrow accounts theoretically to pay for product liability judgments the States might ever recover from them,[5] and 2) the escrow fund payments would not be based upon national sales but only to those States in which they were doing business. Thus, the Escrow Statute, as originally set forth in the MSA Model Statute, MSA Exh. T, contained the Allocable Share Release. It allowed any Non-Participating Manufacturer to obtain a release from escrow of any payments made to the escrow fund of any particular Settling States of any excess over what that State would have received from that NPM as its share of the MSA Base Annual Payment if that NPM would have been a Subsequent Participating Manufacturer. The trial court in *Freedom Holdings* recognized that this was the intent of the Allocable Share Release Provision. *FH III*, 447 F. Supp. 2d at 241-42.

An SPM who joined the MSA after the 90-day period for becoming a grandfathered SPM expired is required to pay the full Base Annual Payment

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[5] No such suits have ever been filed and *a fortiori* no such judgments ever entered against any NPM. Nevertheless, this theoretical justification with proviso that the escrow funds would be returned to them on a 25-year revolving basis was upheld as providing compliance with the Equal Protection and Due Process requirements. *See Star Scientific, Inc. v. Beales*, 278 F.3d 339 (4th Cir. 2002).

without the grandfathered share exemption. Like the NPMs in the Settling States, these non-grandfathered SPMs are all small manufacturers that operate in the deep discount market. For all intents and purposes, these full annual payments disable them from competing since they pay approximately as much as an NPM would pay if it makes the full escrow payment. *See FH VI* at 592 F. Supp.2d at 692.

In 2002, the Counsel of State Governments ("CSG") representing all of the States issued a report warning them that they would "experience a $14 billion decrease in projected tobacco settlement revenue over the next nine years" unless NPM sales were suppressed, *FH VII* Appendix A502. Consequently, the OPMs collaborated with the Settling States in jointly conducting a state-by-state campaign to repeal the ASR and in effect convert NPMs into involuntary Non-grandfathered SPMs, thereby disabling them from competing. A814-18. The campaign, kicked off in early 2003, began to pay dividends starting in that year. The trial court recognized that "[t]he provisions of the MSA motivating State action, MSA Art. IX and the pressures imposed by the OPMs in light of their declining profits" appeared to be the motivating factor for this quick and widespread enactment of the ASR. *FH IV*, 2004 WL 2251668, at *1.

As is apparent from the charts on p. 6 and p. 10, *supra*, once the Allocable Share Repeal converting NPMs to involuntary SPMs began to take place starting in 2004, the MSA output cartel achieved a success unparalleled so far as we know by any other output cartel ever conceived. Starting in 2004, the Majors' operating income began to

attain the record levels that it had attained in 2000 and 2001 while their sales volume continued to decline—with, of course, lower annual settlement payments being made to the Settling States, due to that decline in volume. *See* charts p. 8, *supra*.

ARGUMENT

I. THE COLLECTIVE ENFORCEMENT BY THE SETTLING STATES OF THEIR STATUTES PENALIZING THE OUTPUT OF NPMs IN FURTHERANCE OF THE OUTPUT CARTEL SET UP IN THE MSA IS A CLEAR-CUT VIOLATION OF SECTION 1 OF THE SHERMAN ACT

It is ironic that the Attorneys General of the Settling States whose sworn duty is to protect the citizens therein are actively participating in and enabling the predatory behavior of the Majors in fleecing them.

None of the appellate decisions upholding the legality of these statutes under the Sherman Act, including both *FH VII* and *S&M Brands*, mention, much less deal with the proven fact that, the enforcement of these penalty statutes within the Settling States has virtually wiped out NPM competition within those States—the relevant market for Sherman Act purposes—with the resulting nationwide high prices to consumers. That it has happened is undeniable. Preventing such restraints was what the Sherman Act was designed to prohibit. If such a restraint produced by the collective action taken by most of the States

in the nation does not violate the Sherman Act, then it is reduced to a vapid piece of legislation.

A. Both *FH VII* And *S&M Brands* Are Able To Conclude That The Statutory Enforcement Penalties Do Not Create A Violation Of Section I Of The Sherman Act Only By Their Refusal To Look At The Relevant Market

Neither *FH VII* nor *S&M Brands* provides any explanation as to why they refused even to look at the anticompetitive effects of these output penalty statutes within the relevant market—the Settling States. The elimination of the NPMs in this market is self-evident, as shown by the charts on p. 6 and p. 10.

S&M Brands, like *FH VII*, applies antitrust precepts facially inapposite to these *sui generis* statutory penalties. For example, *S&M Brands*, just as *FH VII* does, concludes that there is no *per se* violation created by these Escrow Statutes because they "did not 'mandate or authorize conduct that necessarily constitutes a violation of the antitrust laws in all cases.'" 614 F. 3d, 172, 176 (5th Cir. 2010), quoting *Xcaliber Int'l Ltd. v. Caldwell*, 612 F.3d 368, 375 (5th Cir. 2010.) But such analysis ignores the objective in the MSA for enacting and enforcing these State penalty statutes. *S&M Brands* does not challenge the point that the State of Louisiana did in fact act "as a private player when it entered an agreement with other States and the OPMs to restrain trade." 614 F.3d at 176. In entering into the MSA, as pointed out above, Louisiana and the other Settling States covenanted with the Majors that they

would enact and enforce these statutes, and that unless they "diligently" enforced them they would be subject to multibillion dollar reductions in their annual settlements. MSA § IX(d)(2)(B). In enforcing these statutes to avoid these reductions, it is the States themselves that "as private players" are carrying out the mandate of the OPMs, not vice versa. Thus, using this test to sanitize this illegal conduct on the part of the States is topsy turvy reasoning.

S&M Brands then goes on to conclude that "the MSA and Escrow Statute working together" do not create an antitrust violation. It relies on this conclusion primarily on a quotation of *Tritent Int'l Corp. v. Kentucky*, 467 F.3d 547, 557 (6th Cir. 2006), to the effect that the "genesis of [the] anticompetitive behavior" complained about by the NPMs results not from enforcement of these statutory penalties on output but rather "the behavior with which *Tritent really* takes issues is the behavior of the PMs following the MSA's enactment," *i.e.*, the "PMs' practice of increasing cigarette prices, thus keeping sales volume down, [which] has allowed them to maintain a stable market share." As facts show, however, these supracompetitive OPM price rises are enabled by and depend upon the enforcement of these State statutory penalties on the output of NPMs. Again, this is a topsy-turvy analysis.

In short, these misapplications of basic antitrust principles in the appellate courts upholding these MSA statutes ignore the indisputable facts that the MSA and its implementing statutes penalize NPM output: a) they were enacted with the objective of compelling the States to penalize the out-

put of non-participants in the cartel, and b) they have enabled the Majors and grandfathered SPMs to overcharge consumers billions of dollars every year.

II. THE SAME UNDISPUTED FACTS ESTABLISHING THE DORMANT COMMERCE CLAUSE VIOLATION ALSO ESTABLISHED THE COMPACT CLAUSE VIOLATION

The agreed-upon covenant, MSA § IX(d)(2)(B), jointly and severally made by the Settling States to the Majors for enacting and enforcing these statutory penalties on output of the NPMs and the achieved objective of raising cigarette prices nationwide, constitute a compact within the meaning of the Compact Clause, Art. I, § 10, cl. 3. The performance of that compact has resulted in a nationwide regulation of the interstate commerce in cigarettes with consumers nationwide paying the price. Unless the Compact Clause is a meaningless provision, this has to constitute a violation of it.

CONCLUSION

The adjudication of the petition for *certiorari* should be held on abeyance pending final resolution of the *Freedom Holdings* petition *en banc* in the Second Circuit.

Dated: New York, New York
November 23, 2010

Respectfully submitted,

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